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ABSTRACT

After the Agenda 2000 reforms of the Common Agricultural Policy (CAP) were decided, commentators suggested that the discussion on the next reform could start right away since the reform agreements were insufficient to address the problems facing the CAP in the next decade, including EU enlargement and the WTO negotiations. A set of mid-term reviews are being organised for 2002-03. Several recent food crises have reinforced the demand for a significant reform of the CAP.

The debate on agricultural policy in the EU has been lively and politically prominent over the past months. However the variety of pressures and demands for reform has made the debate complex – and its outcome hard to predict. This document reviews the main pressures for CAP reform, and the factors complicating it. The analysis pays particular attention to structural changes as well as to institutional and political economy factors in the CAP debate. It also discusses the timing and the political coalitions in the decision-making, and discusses implications from the history of CAP reforms for future reforms.

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A FISCHLER REFORM OF THE COMMON AGRICULTURAL POLICY?

JOHAN F.M. SWINNEN*

1. Introduction

Immediately after the Berlin meeting of the Council of Ministers in 1999 where the final decisions on the Agenda 2000 reform of the Common Agricultural Policy (CAP) were made, commentators suggested that the discussion on the next reform could start as the Berlin reform agreements were insufficient to address the problems facing the CAP in the next decade.[1]

This view was not entirely disputed by the European Commission itself, which had proposed deeper reforms than were agreed upon in Berlin. As a compromise, it was agreed to undertake a set of mid-term reviews around 2002/3, re-examining market developments as well as the situations of the agricultural budget.[2] If nothing else, the mid-term reviews were to identify major problems earlier than 2006, the final year covered by the Agenda 2000 agreement.

While commentators had indicated the need to start earlier with more reforms than in 2006 to deal with market situations, CEEC enlargement, and the WTO, since then several additional factors have reinforced the need for more and earlier reforms. In particular several food crises (BSE, dioxin, foot and mouth disease (FMD)) have caused strong reactions from consumers and environmental groups and caused major political reactions, and demands for a radical overhaul of the agricultural practices in the EU and the policies that supports these practices.

Interestingly, these demands have run counter to some of the traditional critiques on the CAP arguing that the CAP needs to be more market-oriented and less distortive. Instead, some of the recent critiques and calls for reform seem to support more regulation, and more support for certain kinds of production practices.

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[1] See, for example, Núñez Ferrer and Emerson, "Goodbye Agenda 2000, Hello Agenda 2003", CEPS working document No. 140, February 2000.

[2] Specifically, the Berlin summit invited the Commission to assess the operation of the cereal and oilseed system, investigate the cattle market, present a report on the milk quota system, and examine whether the framework set for agricultural expenditures in the financial perspectives is appropriate.

While the food crises took place, other developments with potentially important effects on the CAP took place outside the EU. Several Eastern European countries prepare themselves for accession to the EU. Agriculture plays an important role in their economies and societies, and they are adjusting their agricultural systems to compete within the EU and their policies to make them compatible with the CAP. An important debate centres on the issue whether CEEC farms can have access to the same CAP benefits as EU farmers, in particular direct payments. The budgetary schedule of Agenda 2000 does not include provision for such payments. However, it is increasingly clear that the Agenda 2000 position is untenable. All CEECs are united in their demands that their farms should receive the same support after accession as the farms of the current EU-15 member countries.

Across the oceans, the Bush administration and developing countries are considering which strategy to pursue in the upcoming WTO trade negotiations under the Millennium Round. At the same time, the EU has launched initiatives to open up trade with Mercosur and with the 48th lowest income countries, the so-called “everything but arms” (EBA) proposal. Both trade initiatives have potentially major implications for agriculture as Mercosur includes some major agricultural producers, while the EBA proposal would affect especially the sugar, rice, and banana markets.

Against this background, Franz Fischler, the European Commissioner responsible for Agriculture, Rural Development, and Fisheries has made it no secret that he intends to use the midterm reviews of Agenda 2000 to press ahead with a rigorous evaluation and to propose a set of reforms: “I consider it appropriate to carry out all the requested evaluations concurrently, i.e. in 2002. After all, in agriculture the individual sectors are interdependent. We therefore must and will use the year ahead to prepare the mid-term review.”[3]

If nothing else, the debate on agricultural policy in the EU has been very lively and politically prominent over the past months. However at the same time the variety of different issues and demands for reform from various sources has made the debate extremely complex – and its outcome hard to predict.

In this document I will review the main pressures for CAP reform, and the factors complicating it. I will pay attention to issues of timing and political coalitions, and which lessons the history of the CAP provides for the likelihood and form of future reforms. I will

[3] Fischler (2001), speech at CDU Congress, Berlin, 7 May 2001.

pay particular attention to structural changes as well as institutional and political economy factors in the CAP debate.

2. A (Very) Brief History of the CAP and Agenda 2000

2.1 The CAP

When the CAP was designed at the end of the 1950s and initially implemented in the 1960s the essence was a system of government interventions in the market to support a minimum price for farmers. This domestic intervention system was accompanied by trade measures to make it work: variable import tariffs ("levies") and export subsidies ("refunds") were set to isolate this system from international markets. The system (and the names given to the various instruments) differed between commodities and has become more complex since. The most profound interventions occurred in markets of e.g. sugar, beef, dairy and cereals.

With intervention prices set considerably above market prices, surplus production resulted and the EU shifted from a net import to a net export position in agricultural and food products. In combination these contributed to rapidly growing budgetary expenditures (for market intervention, storage, export subsidies, etc.) and distortions of international markets. Both resulted in pressures for reforms.

While several changes have been introduced in the CAP, the most dramatic reforms have taken two different roads.

In the sugar[4] and dairy markets production quota were imposed to control supply and, thereby, the budgetary effects and market distortions, while maintaining high support prices. Extension of this system to the cereals market was considered but the transaction costs (for monitoring, administration and enforcement) of the system were deemed too high to be practical in the cereals market. With the integration of agriculture in the GATT multilateral trading system, pressure from trading partners also grew. Ultimately, a new approach was decided by lowering support prices to reduce market distortions and compensating farmers through "compensation payments" or "direct payments" linked to the area used (for e.g. cereals and oilseeds) or to animals (for beef). This was the most important part of the so-called MacSharry reforms in 1992.

[4] The sugar regime had quotas already from its inception in the 1960s.

2.2 Agenda 2000

The latest reforms, the Agenda 2000 reforms, agreed upon at the Berlin meeting of the Council of Ministers in 1999, basically "represent a deepening and extension of the 1992 reforms" (Ahner and Scheele, 2000). Price support is reduced further for cereals and beef and the direct payments in these sectors are increased to compensate farmers at least partially for the price cuts. In addition, direct payments for oilseeds will be phased down to the cereals' aid level, and the specific support regime for oilseeds will be abolished. A similar reform with support price cuts and the introduction of direct payments is foreseen in the milk sector, but only from 2005 onwards. In the table wine sector price support mechanisms are simplified, together with a limited introduction of new planting rights and reconversion aid.

The combined result of the MacSharry and Agenda 2000 reforms is, at least for the sectors concerned, a major shift from support through price and market interventions to farm support through direct payments. Figures 1 and 2 illustrate these important shifts, both in terms of total support and in terms of the EU budget.

However, Table 1 also illustrates that the total support to agriculture has not declined. Moreover, some argue that support to agriculture has increased more than indicated by the numbers in Table 1, because compensation through direct payments was based on gross revenue declines, while net incomes have declined much less. [5]

Figure 1 also indicates the growth in expenditures on rural development. The Agenda 2000 decisions imply a "considerable overhauling, streamlining, and consolidation" of the EU's rural development policy under the CAP (Ahner and Scheele, 2000). More than the increase in budgetary allocations, which remains moderate compared to the other expenditures, the growing importance of rural development seems to follow from the official reference to it as the 'second pillar of the CAP':

> [The rural development policy] will in the future be applicable in all rural areas of the Union and is meant to become the second pillar of the CAP. This sounds ambitious, and some critics rightly say that in terms of resource endowment, we are still far away from a real second pillar. This may be true, but the structures to get there have been put in place, the foundations have been laid down and if there

[5] For example, OECD calculations on transfer efficiencies of OECD agricultural policies suggest that the average net income gains from market and price support in OECD countries was only 20% (OECD, 1997). This means that, after factor markets etc. have adjusted to the new situation, a gross income decline of, say, €100 is causing a smaller net income decline. Hence compensation based on gross income decline is overcompensating, the extent of which depends on the transfer efficiency of the direct payments, which are also less than 100%.

> is a political will to build on these foundations in the future, it can be done. Moreover, it may be worthwhile to think more about new approaches to rural development, relying much more on measures of financial engineering to mobilise synergies between public spending and private capital, between grants and credit instruments (Ahner and Scheele, 2000, p.19).[6]

2.3 Did Agenda 2000 go far enough ?

The most important questions remained whether Agenda 2000 will be sufficient to face the challenges of the next decade. Will it be sufficient to keep the internal markets in balance ? Will it leave sufficient room for manoeuvre in the upcoming WTO negotiations ? Will it be sufficient to smooth the way for enlargement ?

The decisions by the Council did not go as far in terms of reforms as the Commission had proposed. Instead of 30% as proposed by the Commission, the Council decided to cut the beef support price only by 20%; instead of a proposed cut of 20% for cereal support prices, it was decided at 15%, and dairy reforms have been postponed to 2005, instead of starting in 2000 as proposed by the Commission.

What is perhaps most surprising on the decision is that a qualified majority of Ministers of Agriculture initially (in February 1999) agreed with a reform package close to the Commission's proposals. However, this compromise was "re-opened" during the final negotiations at the European Council (of Heads of State and Government) in Berlin in March 1999.

Several commentators have evaluated the final Agenda 2000 decisions as being insufficient to address the problems facing the CAP and almost certainly to lead to problems in the near future (e.g. Brenton and Núñez Ferrer, 2000; Burrell, 2000; Núñez Ferrer and Emerson, 1999; Buckwell and Tangermann, 1999). For example, Burrell (2000) argues that:

> These changes are probably inadequate for enabling the EU to keep within its WTO bindings in the coming years. For example, when the cereal price cuts are complete in 2002, it will still be impossible to export without subsidies unless world (dollar) prices are particularly buoyant, or the Euro weakens further against

[6] So far, the rural development policy under the CAP is heavily biased towards agriculture. Out of the 7 subgroups of measures, 5 are completely or importantly linked to agriculture. This link with agriculture reduces the efficiency of the measures. Rural development, by definition, should be targeted much broader than only to farms as agriculture is not longer the main activity in most rural areas, and many rural households no longer mainly depend on agriculture as their main source of income (Blandford, 2000). The bias towards agriculture could also make the rural development sensitive to claims that the payments are not completely decoupled.

> the dollar, and so stocks of wheat and coarse grains are expected to rise unless the rate of mandatory set-aside is increased significantly.[7] … [Moreover,] it is widely considered that the EU has not managed to develop a forward-looking strategy for agriculture in the next WTO round and will, once again, be forced to adopt a defensive position.

In a final compromise at the Berlin Meetings, it was agreed, to anticipate problems from cutting down on the reforms, to undertake a number of mid-term reviews around 2002/03, re-examining market developments as well as the situations of the agricultural budget, as a clearer perspective on enlargement, WTO negotiations, etc. had emerged by then. [8]

In a series of recent speeches and interviews, Franz Fischler, the European Commissioner for Agriculture has made it clear that he intends to use these midterm reviews for proposing further CAP reforms. The recent upheavals in food markets as a consequence of BSE, FMD, etc. have provided Commissioner Fischler with additional ammunition in his argumentation for the urgency of further reforms.

3. The Pressures for Further CAP Reform [9]

The pressures for reform can be summarised under the following headings:

- WTO (URAA and future negotiations
- Other trade negotiations
- Food safety and environmental concerns
- Eastern enlargement of the EU

In the following sections I will discuss each of these factors in turn.

3.1 WTO

Since the conclusion of the Uruguay Round Agreement on Agriculture (URAA) in 1992, EU subsidies to agricultural production and exports are constrained by WTO rules. Among others,

[7] However, others argue that chances are pretty good that the EU will be able to export at least wheat, if not also barley, without export subsidies. It is doing so already most of the time since mid-2000.

[8] The Council has also asked the Commission to prepare a review report on the sugar regime by early 2003, as part of its recent (May 2001) decision to prolong the current regime for another five years (with some changes).

[9] In a review of the history and challenges of CAP reform, Ahner and Scheele (2000) list five motives for the Agenda 2000 reforms: Market developments (including food safety); Growing environmental concerns; The need for rural development; Increasing trade liberalisation; Smoothing the way for enlargement. What is interesting is that the current pressures for reform are essentially the same. Clearly, the recent food crises and its political repercussions have put food safety and environmental concerns more prominent on the list than before, but otherwise the major factors have not changed.

there are restrictions on the total support to agriculture and on both the amount of export subsidies and the volume of exports that can be subsidised.[10]

Several observers argue that the implementation of the WTO has so far caused relatively little effective trade and policy liberalisation in most developed countries, including the EU (Josling and Tangermann, 1999; Swinbank, 1999). Yet, they agree that the URAA is an important factor for the CAP for several reasons:

- The URAA brought the link between the domestic policy aspects of the CAP and its international trade implications to the top of the policy agenda;
- it provided the key incentives for the 1992 MacSharry reforms;[11]
- it created a set of rules for agricultural trade policy;
- it provides a framework for future negotiations, and a continuation of the reductions in the subsidies under the next negotiation round could cause much more serious implications for the CAP.

Although no one expected the next round on agriculture to be easy, initially it looked as if it could be a rather straightforward exercise, at least in concept. The previous round had resulted, if not in much effective liberalisation, at least in a framework to build on in the next round. Specifically, three major areas of negotiation had been identified and measure of progress had been agreed upon and used in the negotiations (indicators on "market access", "aggregate measure of support (AMS)", and volumes and total amount of export subsidies). An optimistic negotiation scenario was that negotiators would merely focus on these areas and negotiate further reductions in these indicators.

However recent developments have seriously undermined this optimistic view:

- the Seattle conference has brought the growing discontent of the developing countries (DCs) with the WTO to the forefront and introduced them as a major and new factor in the negotiations. Not only is this complicating the negotiations it is also introducing much uncertainty since the developing countries are a heterogeneous group themselves which do not all have the same interests and preferences. While DCs agree among themselves that the WTO rules and the implementation system are biased

[10] See for example, Burrell (2000); Josling and Tangermann (1999); Swinbank (1999) for more extensive discussions and analyses.

[11] See Tangermann (1998) for an analysis on how the Uruguay triggered the Mac Sharry reforms.

against them, they diverge strongly in their trade policy preference. Hence, there is not a clear "developing country" position.[12]

- The recent food crises in the EU have reinforced consumers' awareness of food quality issues and may complicate trade negotiations, e.g. on the Sanitary and Phytosanitary measures (SPS) agreement. The polarised debate on beef hormone is an illustration of the problems related to these issues, and such problems may very well grow in the future with growing consumer sensitivity to these issues. These growing demands on grades and standards, reinforced by the food crises and also by growing EU consumer concerns on GMOs, may particularly affect trade with developing countries, which, if anything, are expected to have more difficulties satisfying increased and tighter demands on quality and standards (and on the institutions for guaranteeing them).[13]
- There is still no agenda agreed for the next round, the so-called "Millennium Round". While agriculture has to be on the agenda, both the EU and the US would like other issues, such as competition policy (EU) and labour standards (US) to be included as well.
- The situation of the US government regarding the new WTO negotiations is unclear. While President Bush has several times stressed his belief in the virtue of free trade, the Bush administration has so far spent little political capital on pushing the WTO negotiations to the forefront of its policy agenda. The Bush administration is expected to face a tough battle in securing what is now referred to as "trade promotion authority" (TPA) from a strongly divided US congress.[14]
- Furthermore, even if the Bush administration wins trade negotiating authority, it is unclear to what extent domestic pressure to include environmental and labour

[12] The clearest division is between those net exporters who want better access to developed country agricultural markets – on a preferential basis if possible – and those who want protective mechanisms maintained so that they can protect their own producers, while still keeping highly beneficial access to rich and well supported markets like that of the EU.

[13] UN secretary-general Kofi Annan pointed out in his opening of the 2001 UNCTAD conference in Brussels that EU regulations on aflatoxine cost Africa 670 million US$ annually on lost exports of grains, fruits, and nuts. See also Henson and Loader. (2001) and OECD (2000) for more discussions.

[14] Robert Zoellick, the US trade representative, is quoted in press interviews as saying he expects that the Bush administration will need at least the rest of the year to win such approval from congress (Financial Times, April 20, 2001). Notice that the US government does not need TPA to start the negotiations, but it does need it to conclude them. Yet, with a midterm election coming up in 2002 for the US Congress, if anything, it will likely be even more difficult next year to get TPA approved by Congress.

standards in trade negotiations will affect their stance, and, more specifically what their position will be on several key agricultural trade issues.

That said, there are some hypotheses that can be forwarded on the direction that the WTO negotiations will take. Leaving aside the unclear position of the DCs for the moment, one can identify three main positions on major negotiation issues as domestic support to farmers, agricultural export subsidies and import tariffs.

3.1.1 Export subsidies

Export subsidies are a prime focus of critique in the WTO. The EU strategy on this issue contains the following elements. First, it is arguing that all policies that subsidise agricultural exports directly or indirectly should be included in the negotiations. It refers to the use of export credits in the US and the role of state trading enterprises (STEs) in other countries, including some of the Cairns group. Second, a recent ERS study that concludes that export subsidies have a relatively smaller impact than other policy instruments is now widely used in the EU to defend their use[15] and to argue that export subsidies are much less distorting than often argued.

Still, it seems that export subsidy reductions is the issue where the EU is willing to compromise most. (Although one should always be careful that signals by the European Commission are not necessarily followed by the EU member states.) There is, finally, a realisation that defending export subsidies is untenable both politically and ideologically. How can one at the same time take pride in being a major exporter and player in international markets, and use measures as export subsidies which distort exports and domestic markets of other countries, including both major trading partners and developing countries ?

The Cairns group is proposing the total elimination of all forms of export subsidies. Both the EU and the US seem to be prepared to negotiate reductions in export subsidies, but it is not clear whether they would agree with a complete elimination of export subsidies. A complete elimination could have very significant repercussions for some of the commodity regimes under the CAP.

[15] The ERS report "The Road Ahead: Agricultural Reform in the WTO" by Burfisher et al. (2001) concludes that "Tariffs and tariff-rate quotas account for more market distortions than domestic subsidies and export subsidies. Tariffs and tariff-rate quotas account for most of the agricultural price distortion (52 percent) from agricultural protection and support. Post-Uruguay Round agricultural tariffs remain high, with a global average rate of 62 percent, and an industrial country average of 45 percent. Domestic subsidies (31 percent) and export subsidies (13 percent) have comparatively smaller, direct roles in reducing world prices. The remaining 4 percent measures the interaction effects of the three policies combined."

3.1.2 Domestic support

On the issue of domestic support there is also clear disagreement between the EU on the one hand who wants to maintain as much as possible and the Cairns group on the other who wants to see a reduction as large as possible. Although the US tabled a clear proposal on domestic support reductions in the WTO, including the elimination of the blue box, there remained considerable debate on the effects and WTO classification of US policies.

Under the URAA, a considerable amount of support in both the US and the EU was classified as “blue box” or “green box” support. The “green box” is a category of so-called “non or minimally trade-distorting” support policies. These green box support policies are not restricted under WTO rules. The “blue box” includes the EU direct payments which were introduced under the MacSharry and Agenda 2000 reforms. Initially also a large amount of US support payments fell in the blue box category. However, since 1996, the US has not made use of the blue box.

The URAA includes a Due Restraint provision (the “Peace Clause”), which is in force until the end of 2003. Domestic support measures that comply with the URAA commitments (whether included in the AMS or exempted in the blue box) cannot be challenged under WTO rules (as long as support for individual commodities does not exceed the level decided in the 1992 marketing year). A similar restraint applies for export subsidies that conform to URAA commitments.

Since 1992 two important agricultural policy changes have occurred in the US. A major reform in 1996, the Federal Agricultural Improvement and Reform (FAIR) Act, essentially decoupled most support in US agriculture from production. Since then the US has argued that the remaining payments (so-called FAIR-payments) no longer belong in the “blue box”, but instead in the “green box”, leaving the EU alone in having a major share of its agricultural support payments in the blue box.

However since a few years, the US has been spending huge amounts on additional so-called “emergency farm support” which are officially justified by referring to exceptionally low world market prices.[16] For several years the US refrained from officially classifying the emergency payments with the WTO and merely signalled that it considered these payments as

[16] The Bush government is continuing this practice by announcing a $5.5 billion farm rescue package in August 2001.

being decoupled. There was considerable debate on their decoupled nature.[17] Finally, in July 2001 the Bush government announced that it would place $10.4 billion of emergency aids in 1998-1999 in the amber box.

The FAIR Act has a limited life. It expires in 2002. An assumption has been that the contract crop commodities subject to decoupled FAIR payments will receive no further support after 2002. However, the underlying 1938 and 1949 legislation was not repealed by the FAIR act, and so farm support in the US would revert, by default, in 2002 unless positive steps are taken to avoid this outcome (Beard and Swinbank 2001).

The outcome will depend much on the situation on domestic and world markets. With falling prices and economic pressures on farmers, many observers would expect old programs to return (Ayer 1996). In fact, Hart and Babcock (2001) discuss five different farm programmes which have been proposed for the new and conclude that all would be amber box.[18] Further, they find that introducing them at a level similar to the 1989-1999 programs would cause the US to exceed the amber box spending caps.

Obviously such developments may have profound implications for the EU, because if large amounts of US farm support would be considered trade distorting, this could provide the EU with a strong ally in defending the continuation of the blue (or amber) box. Not surprisingly, the EU is following the developments in Washington DC these days with more than normal attention.

Still, realising that there is an effective danger of becoming isolated in defending the blue-box-continuation, the EU seems to have taken a double track approach here. On the one hand it wants to get as much as possible of its blue box payments into the green box – a strategy not unlike the US approach. In fact, there may be an opportunity for a “tacit coalition” between the US and the EU in a flexible interpretation of green box definitions. Not surprisingly, the Cairns group is strongly opposed to this and, to the contrary, wants to review the current

[17] For example, Bruce Gardner (2000) argues that the emergency payments are largely decoupled as their allocation is mostly based on the same base as the FAIR payments. The main commodity title of the FAIR Act is the Agricultural Market Transition Act (AMTA). “AMTA payments were set up to be fixed regardless of market prices, but in 1998, 1999, and 2000 AMTA payments were augmented by 50%, 100% and 100% respectively, in emerging market loss assistance payments to compensate producers for low prices. Although details are complicated, …, AMTA payments arguably have no effect on farmers’ acreage or other production decisions, since the payment is the same no matter what the farmer does.” (p. 8) and that “In the short run this is essentially a pure transfer from taxpayers, without buyer benefits or deadweight losses. However, it is likely that payments as large as these will keep some farmers in business who would otherwise leave farming.” (p 14). See also Hart and Babcock (2001) for a discussion.

definitions of "non-market distorting" and wants to tighten the definitions as they consider that some of the support measures already in the green box are effectively distorting production and trade.

On the other hand the EU is looking at new ways of defending its agricultural support if it will be unable to win extension of the peace clause. This new defence rests strongly on the concept of the "European farm model" and "multifunctionality".[19] The multifunctionality argument is used as well by other high protection countries such as Norway, Japan, Switzerland, etc.. Arguing that farmers not only produce agricultural commodities but also goods such as rural landscapes, etc. the argument goes that farmers should be compensated for the provision of these public goods.

Notwithstanding that the scientific or economic base for this argument is weak (as reflected in a recent report of the OECD on multifunctionality), several countries, including the EU, have gone ahead and put the multifunctionality concept and what they call "non-trade concerns"[20] at the core of their WTO negotiation strategy. However, several commentators have argued that, besides the weaknesses of the argument, the current CAP is itself inconsistent with the European farm model. Or, in a milder version, as Louis Mahé (2001, 15) recently formulated it: "The European model of agriculture is defensible, [but] the European model of agricultural policy is hard to defend as it stands."

The European Commission has also realised this and in recent statements has indicated that changes in the CAP will be needed to make it consistent with its own vision on the future of farming in Europe. In particular, it is now emphasising that subsidies should be linked more

[18] The programmes include the counter-cyclical Supplemental Income Support (SIS) programme proposed by the Commission on the 21st. Century Production Agriculture.

[19] The "European farm model" emphasizes that farming is a *multifunctional* activity which not only results in agricultural production, but also to environmental public goods (landscape…), high quality food, decent animal welfare standards, rural development, etc. Hence, it is argued, farms should be rewarded by the government (subsidized) for these multi-functional, public good effects which are not rewarded by the market. For a discussion see, for example, OECD (2001), Cahill (2001), Latacz-Lohmann and Hodge (2001), Mahé (2001), Mullarkey et al. (2001).

[20] "Non-trade concerns" can include a variety of objectives, including food safety, environmental objectives, etc… However, if such so-called "non-trade concerns" cause the restriction of imports or the subsidization of products competing with imports, they affect trade, and hence these objectives and policies have trade implications, and therefore should be part of trade agreements. The issue may not be considered a trade concern for one party, but certainly could become a trade concern for trading partners whose imports are blocked. As a comparison: a senior European Commission official recently reflected that "When people told us in the 1980s that agriculture and the CAP would have to be discussed in the GATT negotiations, the dominating attitude in DG-VI in Brussels was one of disbelief: What did international trade negotiations have to do with domestic agricultural policy ?" Hence, apparently, until the Uruguay Round, all EU agricultural policy was considered a "non-trade concern" by some.

closely to the extra cost of more environmentally-friendly farming practices, better animal welfare standards, product labelling and traceability schemes (see further).

Also on this aspect, the EU is searching for an alliance with the US. For example, in a recent address at a US Congressional dinner[21], Commissioner Fischler argues that the five broad principles of future US farm policy outlined by former US secretary of agriculture Glickman are essentially consistent with multifunctionality, and that “Glickman’s concept of a multifaceted agriculture is identical to ours of a multifunctional agriculture”.[22]

The growing convergence between US and EU agricultural policies is also emphasised by David Blandford (2001), who sees similar structural factors driving the policy agenda on both sides of the Atlantic. Furthermore, a recent report by the Dutch Dairy Association (NZO) emphasises the similarity of dairy policies in the US and the EU as a base for a strategic negotiating alliance between Brussels and Washington on dairy policy.[23] As table 2 illustrates, agricultural support levels in sectors such as dairy and sugar in the US and the EU are much closer than average agricultural protection levels.

3.2 Other trade negotiations

The WTO is not the only trade arrangement affecting EU agricultural and food markets and the CAP. Many developing countries have preferential access to the EU market under special agreements, such as the former Lomé, now Cotonou agreement.[24] The Seattle conference has reinforced the position of the developing countries in the international trade negotiations. While they often complain about the negative impact of EU agricultural policies and standards on them, they are a heterogeneous group. They are heterogeneous by the structure of their economies and their international comparative advantage in agriculture and food production.

However they are also heterogeneous in the costs and benefits from current EU agricultural and trade policies. In highly regulated EU markets, such as the sugar and banana market,

[21] Fischler, F., “EU and US Farm Policies: Where do they differ and where do they converge?”, Congressional dinner speech, Washington DC, May 17, 2001.

[22] The likelihood of a transatlantic agreement on multifunctionality may be enhanced by the recent shift in the power balance in the US senate. One of the first actions of the new Senate Agricultural Committee chairman, Tom Harkin, was to submit a proposal to significantly increase government support for agri-environmental measures.

[23] See Agra Europe, May 18, 2001

[24] To illustrate the extent of this factor: among the 141 participants in the WTO, many of them developing countries, the EU has special trading agreements with almost 100.

preferential trading agreements may yield major benefits to some of the developing countries who benefit from this access, such as ACP countries. Therefore, developing countries have quite diverging preferences on reforms of the CAP commodity policies and trading regimes.

Pascal Lamy, the EU trade commissioner has recently taken several new trade initiatives to stimulate both multilateral and regional trading agreements. Among the latter are initiatives for liberalising trade between the EU and Mercosur. With members such as Brazil and Argentina, it goes without saying that liberalisation of agricultural trade within such agreement would have major impacts on EU agri-food markets.

Another recent Lamy initiative, the “Everything but Arms” (EBA) trade proposal was to allow all imports of the 48 poorest countries without restrictions into the EU market. The EBA proposal was heavily opposed by interest groups from the rice, sugar, and banana sector. These strong lobby efforts have resulted in some revisions of the EBA proposal before it was adopted by the Council. The revisions have reduced the impact on those sectors, though only temporarily.[25]

These trade initiatives have raised awareness of the international effects of the CAP and contributed to the sense of a need to reform the CAP.

3.3 Eastern Enlargement

Several Central and Eastern European countries (CEECs) will become members of the EU – the so-called “Eastern Enlargement” -- in the next decade. Agriculture is an important component of this process for several reasons. First, unlike in most sectors, where trade restrictions have been removed already, accession implies the removal of important barriers to agricultural and food trade between the CEECs and the EU. Second, accession implies the imposition of a complex set of policies and rules under the Common Agricultural Policy (CAP), budgetary and WTO constraints, veterinary and phytosanitary rules, and commercial policies, all of which cause politically sensitive accession issues. Third, agriculture makes up a large share of employment in CEECs, especially in the two largest countries, Poland and Romania, which combined have almost as many "farmers" as the EU-15. Low productivity and hidden unemployment indicate potentially serious social and economic problems with accession.

[25] Liberalisation will be phased in for several years for the three sensitive products. For example for sugar, tariff quotas will gradually increase from 2001 onwards, but tariffs cuts will only start in 2006 and full liberalisation will occur in 2009.

Much has been written on the agricultural implications of accession.[26] Here I restrict myself to the question whether a reform of the CAP will be needed to accommodate the Eastern enlargement of the EU. The two most important arguments why CAP reform is needed before accession could take place are the following.

The first argument is that imposition of the high support prices of the CAP on CEECs with their cheap labour and land, and large farms would stimulate output, and at the same time high food prices would reduce consumption. In combination they would contribute to a growth in net exports of the enlarged EU, which would have to be exported with export subsidies, which would *violate WTO constraints* on EU subsidised exports.

The second argument is that the extension of the CAP to CEECs would increase the budgetary burden of the CAP to the extent that it would "*bankrupt the EU budget*" (House of Lords, 1994). The three sources of budget increases were intervention purchases, export subsidies, and direct payments.

We will discuss the budgetary effects later. First, consider the WTO argument. The likelihood of a conflict depends on the WTO commitments of the EU-15 and the CEECs, on how the integration process affects these commitments, and on the supply and demand effects of integration.

3.3.1 Enlargement and WTO

To understand how enlargement will interact with the WTO commitments, one needs to understand how the WTO commitments of the EU-15 and those of the CEECs will be merged after accession. There are no comprehensive WTO rules on how to do this. In GATT terms, accession of the CEECs to the EU is the enlargement of a customs union. There are GATT rules for such cases, laid down in GATT Article XXIV. Essentially these rules apply to tariffs. However, as these rules date back to the times before the URAA, they do not relate to the new types of commitments established under the URAA (Tangermann, 2000).

Regarding *tariffs,* the EU and the CEECs will have to satisfy the other members of the WTO that enlargement does not result in a situation in which the overall level of agricultural protection and support in the enlarged EU violates the aggregate commitments that both had before enlargement. Tariff bindings in the CEECs in many cases are significantly below those bound and applied in the EU so that negotiations will have to be held in the WTO on how to

[26] See for example, Hartell and Swinnen (2000) and Tangermann and Banse (2000).

compensate other countries for the increase in tariffs on their agricultural and food exports to the CEECs.[27]

How to treat commitments on agricultural export subsidies and domestic support is not regulated in these GATT provisions. However, there is the precedent of the EU Northern enlargement in 1995 (Burrell 2000). As far as domestic support commitments are concerned, what happened was that those of the EU-12 and those of the new members states were simply added. It is likely that the same procedure will be adopted in the case of Eastward enlargement.

Concerning *domestic support*, Buckwell and Tangermann (1999) evaluated the effects of the accession of five CEECs (Poland, Estonia, Czech Republic, Hungary, and Slovenia). They conclude that it appears unlikely that the aggregated domestic support commitments of the EU-15 and these five accession countries would provide for sufficient room to cover an extension of the direct payments (DPs) to the new member states if the blue box was no longer available at that time. However, in this case it seems that the DPs would need to be reformed in any case (see further).

The most constraining WTO commitment is the one on *export subsidies*, and more particularly the constraint on the volume of subsidised exports. First, both the EU and the CEECs will find it difficult to respect the existing commitments in some product sectors.[28] Second, with an extension of the CAP surpluses of a number of products in the CEECs may rise, in spite of price reductions in the EU. Increased surplus production in CEECs following enlargement will also imply more subsidised exports (Tangermann, 2000). Brenton and Nunez Ferrer (2000) argue that the EU will violate even existing commitments on the volume of subsidised exports unless there is a substantial upward movement in world prices.

Let us take a closer look at the expected supply effects in CEECs.

3.3.2 Production and Trade Effects

Since the beginning of the CEECs' transition to market economies, agri-food trade between the EU and CEECs has increased dramatically. However, while EU agri-food imports from CEECs have doubled, EU exports to CEECs have increased almost tenfold between 1988 and

[27] From this perspective, it would be convenient to include in a Millennium Round all the Article XXIV compensation negotiations.

1998 (see Figure 2). As a result, the net trade balance for the EU has improved from negative € 1 billion to a positive € 2 billion.

The nature of agri-food trade also changed. While trade has increased in most categories, exports of processed products from the EU to CEECs have increased considerably more than exports of primary products. EU imports from CEECs have increased more or less the same across different categories (Van Berkum, 1999).[29] EU export subsidies; quality differences; the competitiveness of the EU food marketing, processing, and retailing industry; and a more developed institutional framework all underlie these trade developments. Given the recent upheaval in EU food markets caused by the BSE and dioxin crises, quality and safety factors in particular will increasingly affect trade. Both private businesses reacting to consumer demands and EU accession requirements will impose EU standards on CEEC exports. Higher standards have two (opposite) effects. Lower administrative and processing costs of CEEC imports and higher quality will both improve access to the EU-15 market. However, implementation of higher standards will require significant investments that not all CEEC producers and processors will be able to make, and the production that satisfies these requirements will be less than current output.

Agricultural *productivity* in CEECs has increased markedly since the mid 1990s but still falls considerably behind that in the EU-15 (see figure 3). Productivity increased most in countries, such as Hungary, with high foreign investment in the food industry. Foreign investment has improved access to inputs, capital, and technology, and provided positive spillover effects to farms and other sectors (Gow and Swinnen, 1998).

With enlargement, agricultural productivity should increase further, because of the economic conditions that will have been fulfilled and because of improved access to capital, technology, and other factors of production. However there is no consensus about the extent of these productivity increases in the next decade.

Productivity increases seem to be lagging in the two largest countries, Poland and Romania. Both are characterised by unfavourable production structures -- small-scale farms resistant to rapid restructuring and productivity growth (Macours and Swinnen, 2000). These agricultural sectors are also hampered by hidden unemployment, low skills, poor access to inputs, and

[28] The EU exceeded its basic export subsidy allocation for nine out of a total of twenty product groups in 1999/2000, including a 60% excess for coarse grains (WTO Secretariat). This could only be done by using the ‘carry-forward’ provision in the URAA which allows to use ‘unused’ export subsidies from previous years.

[29] See also Bojnec (2001).

inefficient scales. Given the large share of total CEEC land and labour employed by these farms, these deficiencies will be an important constraint on future productivity and output growth for the CEECs.

Furthermore, while figure 3 clearly indicates a recovery in CEEC yields since 1994, yields in the EU-15 continued to increase as well, and hence the productivity gap has not decreased on average. Finally, while one should be careful with this comparison, the impact of Southern enlargement (Greece, Portugal, Spain) suggests that one should not *necessarily* expect a quick catch-up in productivity with accession.

Moreover, in comparison to the immense *trade and policy changes* since 1989, future policy changes and the resulting price and production effects appear moderate (Tangermann and Swinnen, 2000). Four factors have narrowed the price gap between EU and CEECs' agricultural products since the earlier 1990s. First, the MacSharry Reform and Agenda 2000 reduced support prices for some of the most protected EU commodities. Second, agricultural protection in CEECs increased since the mid 1990s, partly because of CAP-imitation in anticipation of accession, and partly because of domestic political pressure from CEEC farms. Third, the appreciation of real exchange rates in the CEECs further reduced the nominal price gap. Fourth, the improvement of product quality in CEECs is increasing CEEC prices as higher quality products receive a price premium. In combination, these developments have reduced the price gap between CEECs and EU, and hence the production and trade effects of enlargement (see Figure 5).

According to simulations by Münch (2000), accession will cause significant price increases only for beef, sugar, milk (and processed derivatives, butter and milk-powder), and coarse grains (barley, maize, rye). However, the average quality of beef in the CEECs falls considerably below EU standards, and costly quality adjustments will offset how the beef sector reacts to higher beef prices. In the current CAP production quota constrain sugar and milk production. Implementation of the CAP therefore implies quota for sugar and milk for all CEECs - and hence no output increase with accession. Alternatively, a reform of these regimes would reduce the price gap and hence the enlargement effects.

No doubt, the implementation and allocation of production quota in CEECs will be very complex because of the absence of obvious reference periods, and because of tremendous administration problems. Many have argued that, even leaving aside the distortions of the policy, this in itself is a sufficient reason for removing the quotas.

Hence, given the arguments above, coarse grains may be the only of the 'heavy' CAP intervention commodity groups for which accession to the CAP causes significant import increases in EU-15. Imports for fruits and vegetables may also increase as trade barriers currently restrict imports of CEEC fruits and vegetables, with quality differences relatively small and low labour costs playing a more important role in these labour intensive commodities.

Our above analysis suggests that accession is less likely to create a conflict with WTO commitments than initially feared -- although several factors, such as the evolution of CEEC productivity, world markets, and exchange rates, remain uncertain. What is also obvious is that a deeper reform of Agenda 2000 would have made a considerable difference here.[30]

Still, the likelihood of a WTO conflict will depend more on the outcome of the upcoming negotiations in the WTO Millennium Round. If, as a result of a new WTO agreement, the EU needs to significantly reduce export subsidies or change the implementation of the direct payments, the CAP will need to be reformed, irrespective of enlargement.

3.4 Food Safety

With rising incomes, consumer demands for food quality and safety have increased over the past decades. This general trend has been strongly reinforced by several food safety crises over the past years which have put food safety on top of the agricultural policy agenda. Both the BSE crisis and food and mouth disease (FMD) started in the UK and spread to the continent afterwards. The dioxin crisis started in Belgium, but had EU wide effects through trade restrictions from other countries.

There were several important effects. First, consumers reacted strongly to these events by reducing consumption strongly. Second, consumers and environmental groups put the agricultural production processes and animal welfare issues on top of the agenda. Third, there were significant political impacts. In Germany, both the Minister of Agriculture and the Minister of Health Affairs had to resign in the wake of the discovery of BSE in the country. In Belgium also two ministers, including the Minister of Agriculture, had to resign following the discovery of dioxin in the food chain and the dioxin scandal contributed to a major electoral defeat of the governing parties. Finally, the EU budget faced significant additional

[30] Given the expected agricultural production effects of enlargement, and their trade implications, the budgetary effects of extra intervention purchases and export subsidies are expected to be relatively minor. The main budgetary effects come when/if direct payments are made available for CEEC farms (see further).

expenditures both because of increased intervention purchases and because of additional policy measures to contain BSE and FMD.

The strong reactions of consumers on this issue contrast sharply with their rather passive attitude vis-à-vis traditional agricultural policy issues. For example, a recent Eurobarometer survey found that only about half of the EU public knows about the existence of the Common Agricultural Policy and 46% even thinks that more government funds should be allocated to EU farmers.

Following these crises strong calls for the overhaul of the EU's agricultural policy have been made. Both consumer groups, environmental organisations, and government officials emphasised that massive government subsidies to farming practices which did not adhere to appropriate food safety, environmental, and animal welfare standards were unacceptable.

Political reactions in Germany were especially strong with the appointment of a senior member of the Green Party as the new Minister of Consumer Protection, Food and Agriculture. She called for a fundamental rethinking of the EU's agricultural policy including a strong shift to organic farming.

4. Reform + Reform = More or Less Reform ?

Interestingly, the various demands for reform are not all consistent and may actually weaken each other rather than reinforce one another. Clearly there is a reinforcement in the sense that "something needs to be done", but there is much less common ground on the direction which the reforms should take. In fact, some of the reform ideas point in opposing directions.

The food safety crisis has significantly contributed to the demand for reform of the CAP, and probably more than anything else put CAP reform on the political agenda and raised public awareness about agricultural policy. However, the reform ideas coming out of this agenda tend to go in the direction of more regulation rather than less, and of more subsidisation, albeit redirected, rather than less. For example, few of environmental groups and parties who have recently pressured for a radical rethinking of agricultural policy in the EU see trade liberalisation and WTO negotiations as a positive development.

This contrasts with the "more traditional" pressure for CAP reform pushing towards less regulation, subsidisation, and intervention and favouring more liberalised trade and markets. For example, while "old reformers" tend to look rather sceptical upon the concept of "multifunctionality" which the EU is pushing in the WTO negotiations as an argument to maintain a large part of its agricultural support system, “new reformers” tend to appreciate this concept as it is consistent with their desire to subsidise and protect a certain farming system.

The contrasting views are well captured in the following quote from Tangermann (2001, p. 54):

> The BSE crisis had absolutely nothing to do with agricultural policy. [It is a puzzle] why organic farming is now so widely seen as the most appropriate response to the BSE crisis, and to Foot and Mouth Disease. … When it comes to economic measures, everything that economists have long preached remains valid, and now even more so. To argue that Europe’s farmers were driven to adopt cost saving dangerous practices because they were under constant price pressure is simply wrong; as is the suggestion that structural change towards larger farms endangers the environment, animal welfare, and consumer protection. Price support cannot do anything good for any of these concerns. Indiscriminate direct payments substituting for past price support help neither the environment, nor animals, nor consumer health. … At a time when surplus beef is destroyed to save the market from complete collapse, who can understand why beef premia are still paid on a per animal basis, providing incentives for farmers to produce more than the market price would suggest ?

In conclusion, the pressure to reform the CAP has clearly increased and it is likely that something needs to be done in reaction to the increased demands. However, it has not contributed to a clearer picture on what direction the reforms will take.

An intriguing question is not only how these new demands on food product and farm processes will affect the agricultural policy towards the EU farms but also how the increased demands will affect trade policy. Higher demands on product quality and production processes, will likely lead to changes in grades and standards for imports. It is not hard to predict that those will create additional trade barriers especially for those countries which do not have the institutions to realise these new requirements, or to guarantee them, i.e. the lowest developed countries.

5. The Future of the Direct Payments

Central in the debate on CAP reform is the future of the direct payments. Direct payments are central in the WTO discussions, in the CEEC accession negotiations, and potentially also in the discussion how to address environmental and animal welfare demands.

Buckwell and Tangermann (1999) argue that a discussion on the future of the direct payments requires first coming to terms with the question what the objective of the direct payments is. Are they compensations for past price declines; or are they measures to support farm incomes; or are they payments to reward farmers for specific activities, such as environmental practices ? After reviewing the implementation and allocation of the DPs they come to the conclusion that the DPs, although initially introduced as compensation payments, now seem to be used for a variety of objectives. In this perspective, Beard and Swinbank (2001) make an interesting comment that, while the MacSharry proposals of 1991 referred plainly to "a system of compensatory payments… to compensate losses of income caused by the reduction in institutional prices", the Agenda 2000 document used terms as "direct payments", "direct income payments", and "direct compensatory aids". They suggest that the change in terminology is probably not coincidental, but rather reflects a shift in thinking about the nature of the payments.

Since long, economists have recommended replacing price supports by decoupled payments. Regarding the direct payments they suggested that the payments should be accompanied by restrictions on time and size, and/or made conditional on other conditions.[31] In 1997, a European Commission advisory group headed by Allan Buckwell had advocated the use of transitional adjustment payments (TAA) which would be decoupled from production, non-distorting to competition, and subject to environmental conditions, and – by definition – temporary during a "transition phase" (Buckwell et al, 1997).

In both the MacSharry reforms and the Agenda 2000 reforms, the Commission proposed more restrictions on the direct payments. However, the Council rejected much of the constraints in both reform decisions.

In itself the shift from (temporary) "compensation payments" to (more permanent) "direct payments" may not be surprising to those who have studied agricultural policies in general.

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[31] In "Brussels-speak" these constraints and conditions are referred to as "degressivity" (declining over time), "modulation" (limitations by farm or size of payment), "cross-compliance" (conditional on other requirements, e.g. environmental). A fourth constraint that has been suggested is "co-financing" (partly financed from the EU budget and partly by the national governments).

Any study of the history of agricultural policies shows the remarkable persistence of "temporary" government interventions in agricultural and food markets (not only in the EU but worldwide).[32] After all, sugar quota were introduced in the 1960s as a temporary measure, and the famous Monetary Compensatory Amounts who were supposed to last only half a year when introduced in 1968/9, outlived several people that invented them.

Still, the fact is that direct payments have now become an important part of the CAP (see figures 1 and 2). The question is whether they need to be reformed to accommodate for the process of enlargement and WTO negotiations. There are several issues to be addressed. The first issue is the interaction of DPs and enlargement. Three questions are important here: Will CEEC farmers receive direct payments ? If so, what are the budgetary implications ? What do these budgetary effects imply for CAP reforms ? The second issue is the interaction of DPs with WTO. Do current and future WTO agreements allow for the continued use of DPs, also in an enlarged EU, or not ? These issues are addressed below. Let us start with the first issue.

6. Direct Payments and Enlargement

6.1 Direct payments for CEEC farmers ?

Several arguments have been forwarded not to extend the direct payments to CEEC farmers. They include the following (European Economy, 1996, Buckwell and Tangermann 1999):

- There is no need to compensate CEEC farmers since CEEC farmers will not witness a price reduction with accession, to the contrary.
- Direct payments will distort the CEEC economies and constrain restructuring. Given the size of the DPs at stake, there will be serious distortions in rural household incomes between those who will benefit and those who will not have access. Since DPs are linked to agricultural specialisation's and farming structures, they will strongly affect regional income differences in countries such as Poland. Factor markets, in particular the land market, will be seriously affected. Finally, the DPs will retard much needed restructuring and labour adjustments since farmers and rural households will retard restructuring to ensure DP benefits.
- Benefits of DPs in CEECs will include many non-rural residents as in several countries land is owned by urban households because of the land restitution process.

[32] For the US: see Orden, Paarlberg and Roe (1999).

However, this differs strongly among countries, as e.g. in Poland and Romania most agricultural land is actually owned by rural or farming households.

- Implementation problems and administrative costs of DPs. Obviously these problems and costs can be huge, and are likely to complicate the process strongly, and to lower the benefits from the payment for the economy as a whole (The intra-country distribution of the benefits and costs may create clear losers and gainers within the CEECs, as much of the costs may be born by the state and the budgets.)[33]
- More effective ways to modernise CEEC agriculture: the need for investments in rural infrastructure, institutions, structural reforms, and to modernise equipment is large in CEEC agriculture, and using budgetary funds for financing these investments is likely to contribute more to sustainable rural development than allocating them to DPs.

However, there are some arguments in favour of extending the direct payments to CEECs, given that EU farmers continue to benefit from them. Obviously the most important argument is one of equality and fairness. It seems inconceivable that for any prolonged period farmers in one part of the EU will benefit from such substantial income support measures, while farmers in another part will not; especially when it is the farmers in the richer parts that benefit, while those in the poorer parts have to do without.

However even in the short run, the political implications of not extending the DPs to CEEC farmers could be significant. For example, in a country as Poland with its large rural population, rural household incomes could be very significantly affected by DPs. Attitudes towards EU accession have already begun to become more pessimistic in recent years as, especially, farmers have perceived EU accession increasingly unfavourable. The failure to provide similar direct payments to those farming households as to Western households, could provide a strong political reaction.

Buckwell and Tangermann (1999) also indicate some economic benefits, albeit second or third best policy approaches at it, i.e. that DPs could to some extent provide a substitute for credit market imperfections, as access to credit, even for working capital and short term investments, is problematic in rural CEECs.

[33] The costs for implementing the CAP in CEECs is significant. For example, Plewa (2001) claims that the costs of preparing for the administration of some of the CAP policies were around $ 180 million in Poland in 2000 and 2001, i.e. the equivalent of 20-25% of the total annual Polish budget for agriculture.

Finally, it is worthwhile emphasising that most of the arguments against extending DPs to CEECs can also be raised against providing DPs to EU-15 farmers. DP transaction costs are large in several EU-15 regions. There are also more effective ways of supporting incomes or to modernise agriculture in the EU. DP benefits get capitalised in land values and benefit others than poor rural households or farmers, depending on the land markets in the member states. Finally, in some regions, such as former Eastern Germany and in Sweden, farmers currently benefit from DPs without actually having witnessed a price decline with accession.

The conclusion seems to be that it is unlikely that for longer than a relatively short transition period, CEEC farms would not get the same DPs as EU farms.

However "the same" will be subject to important negotiations. DPs are based on historical bases of output, factor use, and yields. While the CEECs argue that the historical reference period should be the pre-1989 period given the dramatic fall in output and yields that have characterised the transition, the European Commission is arguing that the pre-1989 period was completely artificial and that output, factor use, and yields were the result of a communist central planning system which has no relevance to a market economy and can therefore not be used as reference period.[34] The Commission accepts the argument that the early transition situation is not a relevant situation either, so their proposal is to use the most recent period as reference for basing the indicators for the DPs.

6.2 Budgetary implications

While the expected budgetary costs are lower than initially expected, they remain very significant.[35] The most recent estimates of budgetary costs of extending the CAP to ten CEECs vary from around €9 to €13 billion annually, once the CEECs are fully integrated and have overcome their structural handicaps (Münch, 2001). Direct payments account for most of this amount. The variation in the budget estimates hinges on assumptions on quota

[34] There is an interesting comparison to be made to what extent the agricultural production and yields were more artificial, i.e. biased through government interventions, in the CEECs in the 1980s than in the EU. The EU-15 DPs are also based on a situation which was strongly distorted by high price support etc. While obviously the nature of the distortions differs significantly, the subsidy indicators (PSEs) calculated by the OECD indicate that on average government support for agriculture was higher in the EU than in CEECs: the average PSE for the 1986-88 period was 44% of the total production value of agriculture in the EU and 37% on average for Poland, Czech Republic and Hungary. Since the PSE during this period reflects mostly market and price support in the EU, this support caused yields and output strongly diverging from what one would refer to as "market-based levels".

[35] Also in this aspect, the decisions at the Berlin Council meeting complicate the enlargement process. The failure to impose restrictions in size and in time on the direct "compensation" payments raise the budgetary effects.

allocations, reference yields, and areas for direct payments. All of these variables are part of the negotiation process between the EU-15 (proposing lower levels) and the CEECs (demanding higher levels).

However, even if those who oppose extending direct payments to CEECs have their way, there will be significant budgetary effects. Those who oppose the direct payments for CEECs (because they distort local economies and slow restructuring) favour structural aid programmes for the CEECs to foster sustainable development.

In itself the discussion on the enlargement implications for the structural funds and regional policies has an important budgetary component. In brief, without any changes in the rules, most of the regions currently benefiting from structural funds would loose this support and most of the structural support would shift to the association countries, as their income is considerably lower than the EU average (see figure 4). Some of the countries, in particular Spain and Portugal, who currently enjoy most of the benefits from the structural funds are demanding for a change in the rules such that they would not loose most of their current benefits with enlargement. In 2001, Spain received 63% of the structural funds budget of €31.5 billion. While currently 10 of Spanish 17 regions receive EU structural funds because their per capita incomes are below 75 per cent of the EU average, Spain fears that all but the two poorest regions could loose support from the structural funds.[36]

The strongest opposition to this argument comes from those who would have to pay the bill for a change in the rules; in particular Germany. A much publicised recent study by Dresdner Bank suggested that if current levels of structural funding are maintained after enlargement, the additional budgetary costs could run up to €40 billion, and Germany's net contribution would double to €21 billion. Several assumptions underlying this conclusion appear unrealistic and other studies (e.g. Pelkmans, Gros, and Nunez Ferrer, 2000) suggest much lower budgetary costs. Still the large amounts involved and the fact that economic growth estimates for Germany for the next year have been adjusted downwards – to the extent that there is a risk that the slowing economy could cause the Berlin government to break its commitments under the EU's stability and growth pact – have caused a strong negative reaction from Germany on suggestions to continue the current level of structural payments to EU-15 member states.

[36] After enlargement, a large share of these funds would go to Poland under current EU rules. Some estimates show that 30% of the total structural funds would go to Poland.

The discussion of linking a transition period in structural fund payments (initially requested by Spain and Portugal) to a transition period in labour migration from CEECs (requested by Germany and Austria) has so far not produced any results. While Germany remains on its position so far, there may be some room for compromise. In Joschka Fischer's words "it had always been clear that there would be no 'abrupt end' to special aid".[37]

In any case, the pressure by Spain, Portugal, and possibly Italy, to have some transitional phase-out period for its structural aid will add to the budgetary pressure caused by the direct payments.

7. Budget pressures and CAP reform

Budget pressures are often identified as a prominent factor for CAP reform. However, looking at the past suggests that the interaction between the EU budget and CAP reforms are much more complex than that. If anything, the EU budget spent on the CAP has increased rather than decreased with the last reforms, although it has decreased as a share of GDP. This observation is inconsistent with the simple view that budgetary pressures will induce CAP reforms. In fact, the impact of the 1990s reform is opposite: the MacSharry and Agenda 2000 reforms have increased the budget for the Common Agricultural Policy, although EU agricultural expenditures have declined from around 2.5% of GDP in the second half of the 1980s to around 1.5% in 1999.[38]

What seems to have changed in the past is the unpredictability of the budget outlays. In the 1970s and early 1980s rapidly growing supplies with slow growth in demand, caused massive surplus production with large budget outlays for intervention purchases, storage costs, and export subsidies. The reforms of the 1980s did not reduce the budget costs, but rather made that the costs for the milk and sugar regime did not grow further and became more predictable, preventing regular budget crises. The MacSharry reforms and Agenda 2000 have not reduced the budget outlays, quite the contrary, but the nature of the payments has shifted considerably. While in the early 1990s most of the budget was still spent on market and price support, this share has declined strongly. More specifically, direct payments have increased from less than 10% of the agricultural budget in 1991 to close to 60% by 1997. When Agenda

[37] As quoted in the Financial Times, May 17, 2001.

[38] Of course, over the same period the share of agriculture in GDP has declined significantly as well, and total support to EU agriculture has not declined (OECD).

2000 will be fully implemented, around two-thirds of the budget will go to direct payments, and less than 25% to market and price support (see figure 1).

What will be the impact of budget pressures on future CAP reforms ? There are several potential effects.

Budget pressures could stimulate a reform of the direct payments. Reducing the budget costs of the compensation payments can be done in three ways: first by limiting them over time ("degressivity"); second, by limiting the amount per farm or linking them to the size of the farm ("modulation"); or third, by having them co-financed by the member states ("co-financing").

However, on the other hand, budget pressures may complicate efforts to reform sectors such as dairy and sugar where price and quota cuts may not be politically feasible unless farmers are compensated through payments per head or per hectare, as was done in other sectors. Agenda 2000 already includes compensation payments for dairy farmers to compensate for price reductions between 2005 and 2007 (5% annually).[39]

However, from a budgetary perspective, increasing direct payments to compensate for a much more radical dairy (or sugar) reform than in Agenda 2000 is not obvious. Even Beard and Swinbank (2001) admit in their proposal for a radical reform of the DPs that sugar and dairy reform, which they find long overdue, is problematic since the necessary funds for compensation are unlikely to be available until compensation payments for the other sectors start decreasing over time.

From a political economy perspective, the implications are important. The previous reasoning suggests that reforms in the dairy and sugar sectors may reinforce pressure for reforms of the direct payments; but also that those who are opposed to the dairy and sugar reforms have allies in those who are opposed to the direct payments reforms. Moreover, as sugar and dairy farmers perceive the compensation payments as less generous as those initially allocated to other sectors, their opposition to reforms may be stronger than otherwise. The outcome is difficult to predict since it depends on the dynamics of the political process, and the political coalitions, not only across countries, but also between finance ministers and agricultural ministers.

[39] While the European Commission has submitted these as blue box measures, both Beard and Swinbank (2001) and Buckwell and Tangermann (1999) agree that these payments do not fulfill the requirements for blue box, and instead should be categorized as amber box, subject to reductions.

8. Direct Payments and WTO

The blue box as such is not time limited, and hence can only be removed through negotiations, or after being challenged in the WTO. The Cairns group has indicated its strong desire to have the blue box removed, and to challenge the blue box payments as soon as the peace clause expires.

In this perspective, there have been several proposals to reform the direct payment system by making the support truly decoupled so that it would fit into the green box. For example, Beard and Swinbank (2001) and Swinbank and Tangermann (2000) propose to move towards a system which would convert, through several steps, the current system of direct payments into a system of bonds, which would be truly decoupled, i.e. no longer linked to land use or animals.

The reform strategy of the European Commission as outlined in recent presentations by Commissioner Fischler (see further) seems to be to shift as much support as possible from the blue box to the green box in two ways: partly by providing support to small farms on a simple contract of "good farm practice". This would make the payments truly decoupled and that should allow to fit them into the green box.

The second strategy is by tightening some of environmental conditions ("cross-compliance") of the remaining payments. It appears that the Commission banks on three different arguments: either they can be sold as green box, or – in coalition with the US -- some of the blue box will survive the negotiations, or under the "multifunctionality" argument, a new box may develop – either through relaxing the green box conditions (*light green?)* or by tightening the blue box conditions (*dark blue?*).[40]

Beard and Swinbank are critical of this strategy and argue that increasing cross-compliance "*will not make blue payments green*". They argue that "*although the green box does specifically provide for 'payments under environmental programs', the EU's trading partners are unlikely to allow such a flagrant misinterpretation of the [URAA] to go unchallenged*" (p.141) and "*cross-compliance will not turn unacceptable blue-box payments into a GATT-compliant green-box scheme*" (p.142).

[40] Professor Gulati from IFPRI, while arguing that the various boxes have been mostly benefited rich countries, made the case for putting all support into a single box. However, he also pointed out that, as difficult political negotiations tended to end up with complex outcomes things could actually go off in the opposite direction. The current system of amber, blue, and green boxes could proliferate with more categories emerging, such as "multifunctionality box" and a "development box".

Others, however, argue that there is an economic case for revising the green box conditions to include positive multifunctionality effects (see e.g. Latacz-Lohmann and Hodge (2001)).

9. Timing

The timing is complicated. Several major developments, which all affect each other, overlap: the WTO negotiations, the enlargement negotiations and the process itself, the Agenda 2000 implementation, the mid-term reviews, etc.. Box 1 summarises some time schedules and deadlines which are important for the reform process.

The implementation of Agenda 2000 is ongoing, but the full impact will not be realised until 2006. The budgetary guidelines are decided until 2006. The midterm reviews are scheduled to take place in 2002 and 2003. If the Agenda 2000 decisions will not be changed, the dairy quotas will remain unchanged until 2006 and will continue in some form until 2008.

Elections in the member states complicate the decision-making process on further CAP reforms. There is a general feeling that not much will happen, and certainly no difficult decisions will be taken regarding the reform of the CAP, before the French elections in the spring of 2002. Furthermore, some crucial decisions may be delayed even further by the German elections in the fall of 2000. Germany plays a prominent role in the discussions given the sensitivity of both the budgetary implications, as well as on the environmental issues. On the other hand, the current German government may want to insist on some CAP reform decisions – presumably pro-consumer and pro-environment – before the elections to show the electorate their results.

The second term of Commissioner Fischler runs out in January 2005 and he is keen to leave a legacy in terms of having reformed the CAP towards a course which he considers sustainable and consistent with his view on European agriculture. This goes beyond the Agenda 2000 reforms. He seems strongly motivated to use the midterm reviews of 2002 and 2003 to propose a significant reform of the CAP, and, in a rather strange way, the food crises from the past years may reinforce this agenda. The sense of urgency for a significant rethinking of the CAP, unlikely as it may seem, may actually have contributed significantly to pushing the political agenda closer to his preferences. With the last midterm reviews scheduled in 2003, and meetings and discussions taking some time afterwards, 2004 seems like a likely year for the next CAP reform, also since accession is not likely to occur before 2004 (see below). The main reason why it could take place earlier is if the WTO Peace Clause is not extended.

Despite much pressure from the CEECs, there is no agreement yet on a time schedule for the enlargement. Neither is there a decision on which countries will accede first – a decision not independent from the timing decision. Negotiation of the accession chapters are now ongoing with the CEECs.[41] Agriculture is a large chapter and considered one of the most difficult ones. Currently all CEECs have submitted responses to the questions posed by the European Commission and requests for modifications and exceptions in applying the acquis communautaire. One of the most important is the request for a exceptions for foreigners to purchase agricultural land during a transition period after accession. The next steps are expected to last at least until the middle of next year, and depending on whether crucial decisions on the accession process imply more general decisions on the CAP and the budget, these may take until the end of 2002 or 2003 to be decided.

Experts say that the ratification process in the EU members states, which will then need to follow, will take 18 to 24 months. Adding this time frame, suggests that the time of accession may not occur until the end of 2004 or early 2005. Since the Prodi Commission has made accession one of its top priorities, it would certainly like to see some CEECs accede during its tenure, which runs out in January 2005. This makes the turn of the year 2004 – 2005 a likely time for accessing.

This logic puts accession a bit later than statements at the June 2001 Göteborg Council indicating that some CEECs would participate in the European parliament elections in mid 2004 as “full members”. An earlier declaration at the Nice Council meeting (fall 2000) had merely invited the first CEECs to participate in the 2004 elections for the European Parliament without explicitly linking this to membership.

The WTO Millennium Round is behind schedule, with little progress being made since the Seattle meeting. While negotiations on agriculture have continued by the submission of negotiation positions by the various partners, clearly much more is needed in order to make substantive progress. The WTO discussions seem to be gaining some momentum at this moment. The new Bush administration is getting its house in order and the new US-EU trade team, i.e. trade representative Robert Zoellick on the US side and commissioners Lamy and Fischler, have already obtained a first success by finally negotiating a solution to the banana dispute. It is unclear so far whether and, if so, when the Bush administration will obtain fast

[41] At the end of June 2000, Hungary and Cyprus had 22 chapters closed, followed by Slovenia (20), the Czech Republic, Estonia and Slovakia (19), Lithuania (18), Malta (17), Poland and Latvia (16), Bulgaria (10) and Romania (7).

track negotiation authority from the US congress – further complicated by the recent loss of the Republican (de facto) majority in the US Senate due to the defection of a senator from the Republican party. In press interviews, Zoellick has suggested that, in the best of worlds, it will take until the end of the year to obtain such authority from congress.

That said, various parties consider the meeting in Qatar in the fall of 2001 as a crucial point. There seems to be a realisation that one cannot afford two false starts, and minds are focusing to have some substantial points on the agenda.

For the EU, the WTO negotiations cannot go on forever without some decision, albeit a decision to continue the current system until a new agreement is reached, since it is faced with the important deadline of the end of the Peace Clause, which is scheduled to run out in 2003.

According to the above logic, it looks unlikely that the CEECs will accede to the EU before the Peace Clause is running out. The CEECs and the EU have anticipate this scenario by aligning their WTO negotiation positions and consulting each other on the negotiations.

This said, the interaction between enlargement, WTO negotiations, and possible further CAP reform is complex. The dairy sector well illustrates this complexity. The quota system will, according to current legislation, remain in place until 2008. However, the Berlin summit decided that the milk regime will have to be reconsidered in the mid-term review in 2003, "with a view to eliminate quotas after 2006". This means that accession negotiations, which include discussion on dairy quota allocations and direct payments, between the EU and the CEECs are happening at the same time as the EU is reviewing these policies and discussing reforms. Furthermore, accession negotiations may be completed for some CEECs in 2002. Hence, with mid-term reviews to be published end of 2002, beginning of 2003, and French elections in 2002, serious discussions may not start until after this point which raises several complicated issues of ratification and re-negotiations. Finally, even if the EU decides to liberalise the dairy regime, either for internal political reasons or as a result of the WTO Millennium round, a complete removal of dairy quotas is unlikely to take place before the first enlargement round. Consequently, even with substantial dairy reforms either the EU must implement quotas in CEECs, or it must manage, at least temporarily, a quota regime in the EU-15 with a no-quota regime in CEECs, presumably within a single market. In addition, policy makers must address the issue of compensation payments to CEEC dairy farms. These difficult policy decisions are caused by the failure of the 1999 Berlin Council meeting to agree on further and earlier reforms in Agenda 2000, particularly for dairy.

Timing

<u>Agenda 2000</u>	
Midterm reviews	2002/3
Full implementation:	2006
<u>Internal EU politics</u>	
French elections:	May and June 2002 (parliament & president)
German elections:	September 2002
Prodi Commission:	Until January 2005
Fischler Commissioner	Until January 2005
<u>EU Presidencies</u>	
Belgium	Fall 2001
Spain	Spring 2002
Denmark	Fall 2002
Greece	Spring 2003
<u>Enlargement</u>	
CEEC participation in elections for EU parliament	June 2004
First accession wave :	2004 ??
<u>WTO</u>	
US	
Trade Negotiation Authority:	End of 2001 ??
Seattle conference:	Nov/Dec 1999
Sessions on agriculture:	since Jan 2000 (+/- 3-monthly)
Qatar conference:	November 2001
Peace Clause:	Until December 2003

10. The Pro- and Anti- Reform Coalitions

During the Agenda 2000 discussions a rather strong coalition supported the Commission proposals for reforms which went further than was ultimately approved by the Council Meeting in Berlin. They included Denmark, the Netherlands, the UK and Sweden. However, despite that the reform proposals were already approved by the Council of Agricultural Ministers, the opponents, led by France, got their way by opening the discussions again at the European Council in Berlin and by mitigating most of the reforms and blocking (postponing) some key aspects. The reform coalition, who had a blocking minority, unravelled as the UK considered its budget rebate more important than the CAP reforms.[42]

[42] Italy was also part of the group, but Italy's reform position was considered by many to be strategic rather than fundamental. When offered more production quota, its position changed.

The reform coalition seems to have strengthened since then. Most of those in the reform camp seem determined not to be outmanoeuvred again by France. Portugal has recently launched its own ideas for a significant reform of the CAP, proposing more decoupled aid and reinforcing environmental conditions. More importantly, the reformers seem to have gained support from a big friend. Since the BSE crisis and the change in the German government, the German government now supports a significant reform of the CAP, although its ideas on "reform" may differ significantly from other members of the pro-reform group. The reform coalition's hand seems also strengthened by the urgency felt all through European society that policies need to be reformed to prevent food crises from occurring.

The latter reflects the active role and interest that consumers and environmental groups are taking in the reform discussions. Furthermore, and more so than in the past, the trade commissioner has taken an active role in agricultural trade. While previous trade commissioners, e.g. Leon Brittan, disliked the CAP and its trade effects, they did not take an active role in the CAP discussions unless forced to. In contrast, Pascal Lamy has realised early on that the CAP is a key factor in almost any trade negotiation of substance the EU wants to pursue. Therefore he has both taken an active interest in the CAP reform discussion, and taken several trade initiatives which put the CAP under pressure, making it clear that an EU trade policy that was run conditionally on the approval of the agricultural ministers is on its way out. The latter also reflects that the non-agricultural industries, looking for trading opportunities, have realised that the CAP presents a major obstacle for themselves, and are actively lobbying to make the necessary changes to prevent this from happening again in the future. In summary, it seems that consumers, environmentalists, as well as other economic sectors have taken an active interest in CAP reform, and joined forces with those pressing for CAP reform.

Besides the pressure from non-agricultural sectors in the trade arena, several other non-agricultural issues are likely to have an important influence on the CAP reform discussion. Interestingly, all have a "large country" as a major player involved. First, Germany (and Austria) want to constrain labour migration from Eastern Europe after accession. Second, Germany wants to reduce (or control increases in) its financial contributions to the EU. Third, Spain (and Portugal), as major beneficiaries of the structural funds, are concerned that the eastern enlargement would significantly reduce their benefits from the structural funds.

If it wouldn't be for Germany's budgetary problems, there seems to be a straightforward compromise between the demands by Spain and Portugal and those by Germany and Austria. However, Germany's budgetary problems make the discussions much more difficult. The stand-off between Germany and Spain on this issue may make it easier for France to gets its way on the CAP. Although there have appeared some disagreements between Chirac and the Jospin government on CAP reform, no matter who will win the elections is likely to take a strong pro-agricultural negotiation position.

With Germany having two important issues on the table, the support of France in these discussions would be highly welcome. And with Germany playing a key role as a crucial addition to the CAP reform coalition, the support of Germany for the French position in agriculture could prove crucial as well.

Potentially the largest conflict between both on CAP reform is in proposals which have EU budgetary implications. Germany, as a net contributor to the CAP, is likely to favour expenditure cuts, while France, as a net beneficiary of the CAP, is likely to oppose them. Hence, any reform which would cause a partial re-nationalisation of the CAP, such as co-financing of the direct payments; or a significant shift to rural development with co-financing, is likely to have both on opposite sides.

However there are areas for joint positions between France and Germany. After all, the position of Germany is heavily inspired by environmental and food safety concerns, and its denunciation of the "industrial model of agriculture", more than by its strong feelings for liberalisation of agricultural markets. There is a clear potential consensus on modulation of direct payments. In fact, France is one of the few member states already implementing modulation. Hence making modulation compulsory will not meet opposition from France, while it could be presented as a part of a significant CAP reform in Germany with significant funds being made available for organic farming, better environmental practices, etc.; and by making all support conditional on better farming practices. In fact, in a joint article in Le Monde, the French and the German Minister responsible for agriculture, Jean Glavany and Renate Künast, emphasise the need to make modulation and/or degressivity compulsory across the EU.[43]

[43] "*Nous voulons … rendre obligatoire, à l'échelle de l'Europe, un méchanisme communautaire de modulation ou de dégressivité des aides*." In Glavany and Kunast "Agriculture: la réforme en continu", Le Monde, July 30, 2001.

However, the German position on CAP reform and its position on modulation also depends on the influence of the Eastern länder, with their large farms which oppose modulation. The recent policy debate in Germany illustrates this well. Despite the clear reform intentions and a great deal of political capital used, the German minister, Renate Künast, failed to overcome opposition from the federal states (Länder) to introduce the maximum modulation and use the funds for rural development and agri-environmental measures. The agreement reached in July 2001, only allows to divert 2% of direct payments in 2003 for rural development projects. Furthermore, it is not clear whether the German government will be ready to take political risks in the CAP reform debate in an election year.

Also other developments may have an effect. For example, the new Berlusconi government in Italy is already signalling its reluctance to support enlargement if this would imply reduction of EU support for its poorer regions such as the Mezzogiorno, thereby lining up with Spain on this issue.

10.1 Enlargement and Reform Coalitions

Finally, a word should be said about the post-enlargement politics. Or, more generally, how will enlargement affect the discussions on CAP reform because, to some extent, the CEECs may already affect the CAP reform debate before becoming members. Clearly, they have a stake in the reform debate since the outcome will effect them as much as the current EU-15 member states (see also discussion on timing above).

There are indications that CAP reform is likely to become even more complicated with enlargement. While one can more or less group the different countries in terms of more or less protectionist vis-à-vis agriculture, it is likely that Poland will play a crucial role. Poland is a large country, around 40 million inhabitants with a very large share of them linked to or depending on agriculture. Its farming structure is developing into a dual structure: on the one hand a relatively small number of well structured, competitive, modern farms producing on around 20% of the land; on the other hand a large number of small, poorly structured farms using the large majority of the land, and depending on subsidies to survive in the single market. If the current political economic situation is anything to go by, these small scale farms are likely to have a strong influence on the Polish position in agricultural policy debates. So far, Polish agricultural policy has provided support to agriculture, but rather moderately compared to the EU. However, the main constraint for Polish policy-makers in their support for agriculture seems to be the Polish budget. Of course, all of this will change if it is no longer the Polish taxpayer but rather the EU taxpayer who will foot the bill for the agricultural subsidies.[44]

Furthermore, if the past EU-Poland negotiations are a good indicator, Poland is likely to take a strong stance in the EU forum on this issue. Poland has not been afraid in the past years to play tough with the EU in on agri-food sector negotiations, e.g. witness the stand-off in the double-zero trade negotiations. Combining all these factors suggest that there may be a very strong French-Polish axis in the make in agricultural policy debates in the enlarged EU.

Finally, it may be worthwhile to make an extra note on dairy policy. As explained above, the issue of dairy reform is already very complex in terms of timing and implementation in the nexus of enlargement/quota negotiations -- midterm CAP reviews -- agenda 2000 commitments – WTO etc. It is unlikely to become any easier after accession. Dairy policy is very important for Poland, and particular for many small Polish farms. The current restructuring that is going on in Poland in terms of the implementation of investments and restructuring to meet the EU sanitary requirements and modernisation of its dairy farms and processing facilities, with significant social implications, is quite impressive (Dries and Swinnen, 2001). Yet, the structure of much of Polish farms will remain such that dairy quotas will be considered as an important source of survival insurance in a European market, and removing them, after being implemented with high prices may prove even harder after enlargement than it was before.

11. Lessons from the History of CAP Reforms

Looking back at past reforms of the CAP, one can draw several lessons which are of relevance for discussing the likelihood and forms of future CAP reforms.

First, significant changes in the CAP have taken place. Those who see the CAP as a vestige of special farm interests who have the decision-makers under control and of bureaucrats who have a vested interest in the status quo, tend to overlook the significance of some of the reforms that have taken place in the past 20 years. It is clear that when the pressure for reforms grew too strong, either from inside the EU (e.g. budget) or from outside the EU (major trading partners, US, GATT) that significant reforms have taken place.

Second, the reforms have not always improved the efficiency of the CAP and EU agriculture. For example, economists tend to argue that the introduction of dairy quota in 1984 has solved

[44] Actually all CEECs would be net beneficiaries from the EU budget if direct payments were to apply to them.

some of the symptoms of the CAP problems, such as structural surpluses and budget expenditure increases, but that it has cemented rather than resolved the economic inefficiencies in the dairy system.

Third, it is hard to avoid the conclusion that the CAP and the policy-system which decides on its reforms, is extremely resistant to change. More specifically, two factors seem to characterise the significant CAP reforms: they are only agreed upon if there is “no-other-way-out”; and they take the form of the “minimal-change-to-meet-the-critical-constraints”. For example, in cases where there is uncertainty on some future conditions which affect these critical constraints, decisions tend to take the form of “let’s-wait-and-see-first”. The result is that the CAP has a history of postponing decisions and crisis-management.

What does this imply for the future ?

It implies that we should be looking for the most constraining factors, both in terms of their impact and in how certain they are. Three key policy constraints stand out.

1. Food safety and environmental concerns need to be addressed. Consumer and environmental organisations, as well as several governments have made this a key argument for CAP reform. The environmental concerns can be relatively easy addressed (at least at the decision-making level) by tightening environmental requirements, but it is unclear how CAP reforms can address food safety and quality demands.
2. The WTO negotiations are likely to become a key constraint. While there is plenty of uncertainty at this moment regarding the WTO negotiations, there may be considerable progress, at least in the negotiation positions and the likely direction of the outcomes, by 2003. One should expect significant pressure to reduce export subsidies and blue box support.
3. Budgetary pressures will grow with enlargement. Hence the reforms will have to address the budgetary pressure of the growing needs for structural funds and CAP expenditures with enlargement and the demands by the net contributors to keep the budget under control.

The CAP reforms will have to address at least these pressures and constraints.

12. A Hint of the 2004 Fischler Reforms ?

There have been regular press reports on reform ideas from various sources, including from sources close to key EU governments such as France and Germany and from inside the European Commission. However, many of these media reports either form part of the well-known game of politics or have been focused on some specific agricultural policy issues. A first post-BSE/dioxin/FMD-crisis attempt to present a comprehensive reform strategy was recently contained in Franz Fischler's address "*The road ahead for EU agricultural and rural policy*" to the CDU congress in Berlin on May 7, 2001.[45]

The principles of the Fischler proposal are the following:

- tighten environmental/animal welfare requirements for CAP support, by increasing cross-compliance and/or by introducing "good farming practice" requirement;
- address food safety and quality requirements by closer monitoring and a supply-chain approach, and stimulating market-based solutions, including brands building;
- make modulation (which exists already up to 20% for those member states who want to use it) compulsory at 20%;
- shift these 20% (€5 billion) to rural development;
- shift all compensation/aid for environmental/landscape contributions under "rural development";
- simplify and decouple support for small holdings by providing "lump-sum payments" based on "proof of environmental-friendly maintenance of production capacity" only;
- allow funding of rural development activities outside agriculture.

The first interesting thing about the proposals is about what is not in the proposals. There is no mention of reforms of specific commodity regimes, such as dairy and cereals. While Fischler emphasises that the Commission intends to go ahead with thorough evaluations of the commodity sectors for which it has a mandate for the mid-term reviews, there are no indications whether or not any significant reforms are to be expected in these areas. This in itself may suggest that there is, as of yet, too much uncertainty in these areas to come up with clear and 'unavoidable' reform proposals, both because of the market conditions, enlargement

[45] A summary of the main proposals can also be found in Fischler's opinion piece in the *Financial Times* of May 9, 2001.

negotiations, WTO uncertainties, and because of the budgetary implications. Another interpretation is that such specific proposals will have to wait until after the French elections.

In terms of food safety, Fischler's proposals reflect the belief that the CAP can change the way farms produce agricultural products, but has only a limited impact on the rest of the food chain, and hence food quality and food safety issues for consumers should be addressed as part of a much broader approach, relying heavily on the food industry's capacity to monitor the products throughout the chain, using novel technologies etc.

In terms of the farm support system, all proposals have one main aspect in common : shifting support from "direct payments" to "rural development". This shift addresses two key constraints from the Commission's point of view: regarding the WTO, support is shifted from the blue box to the green box, and for the budget, there is a shift from EU-financing to national co-financing. At the same time the tightening of the environmental requirements should provide domestic support from environmental and consumer groups, and can be used in international trade negotiations to strengthen the case for the "multifunctionality" of EU agriculture.

There are both encouraging and worrying aspects on the Fischler proposals for the shift from direct payments to rural development. They have to do with real versus cosmetic changes in the nature of the payments.

Some of the proposals suggest much more decoupling than the EU was ready to consider so far. For example, the proposal to provide support to small farm holdings simply based on "good farm practice" requirements would go a long way into the direction of real decoupling. Fischler states that, if 5000 DM (€2500) is set as upper limit for this measure, more than two thirds of all EU agricultural holdings would fall within this scheme. The proposal may have important implications for the accession countries and the process of enlargement. For example, in a country such as Poland the large majority of its farms would fall within this category. By reducing the administrative requirements for obtaining support, it would make payments accessible for more, and especially, the smallest and poorest farms.

A worrying aspect of the Fischler proposals is that some of the reforms seem to be more cosmetic, and primarily intended for WTO use rather than for effective reforms. For example, Fischler argues that "rural development can also be considerably enhanced by 'redefining' some current aid under the market organisations so that it can be incorporated into the second pillar of the CAP and hence form part of rural development instead" (p. 5). It is not clear what is meant by "redefining", but already now, the Cairns group is concerned that some of the EU support which is in the green box is more than "minimally" trade distorting, and discussions of "redefining current aid" to shift it to the green box will not alleviate these concerns. In contrast, they may reinforce their pressure to renegotiate the green box conditions. Furthermore, as argued by Beard and Swinbank (see above) increasing environmental cross-compliance is unlikely to make "blue" payments "green" by the current definitions of the WTO boxes.

Finally, it should be emphasised that to successfully address the problems of EU farming, rural development should not be seen as an instrument to satisfy WTO constraints or pressure from environmental groups, as reflected also in the explicit link between "environmental and landscape objectives" and "rural development" in Fischler's proposals. It makes more sense to make rural development – in the full meaning of the concept -- the objective of EU policies, and not an instrument to address political constraints. The proposal to allow funding for rural development activities outside farming picks up an idea forwarded by the European Commission in the Agenda 2000 discussions, but which did not survive the political negotiations. The proposal makes obvious sense, although it may not go far enough.

In fact, it is hard to refer currently to the second pillar of the CAP as "rural development" since most of the funding go to agricultural-related activities, or to very specific activities such as "crafts, agri-tourism, etc.". Even in most rural areas of the EU, agriculture is no longer the most important economic activity, and growth and "rural development" comes primarily from other sectors. Even most farming households obtain a significant, and growing, share of their household incomes outside agriculture and non-agricultural activities are important for farming households: on average, in France the share of non-agricultural incomes in farming households is 30%, in Germany even 70%. EU agriculture is characterised by a tendency towards the emergence of a bimodal distribution in farm size, i.e. a small number of large farms that tend to obtain most of their income from farming, and a large number of small farms for which agricultural activities provide only a small part of total household income.[46] Non-agricultural activities play an increasingly important role in the well being of farmers in industrialised countries (Blandford, 2000).

[46] The accession of the CEECs will reinforce this bimodal distribution. All countries have a large number of small scale subsistence farms. Further, in countries such as the Czech Republic, Hungary, and Slovakia a substantial number of very large scale farms have survived the transformation and while those which are poorly managed will probably disappear in the coming years, a significant number of (very) large farms may well become quite successful and competitive in the EU single market.

More importantly, the non-agricultural activities in rural areas are key to farm household incomes an policies should focus particularly on removing constraints for farming families to participate in non-agricultural employment opportunities instead of constraining these by linking support to farming. This is not only important from the perspective of rural development but also for farm household incomes themselves.[47]

[47] Bruce Gardner (2000a) concludes, based on a long run study of US farm incomes, that "*there is no identifiable connection between variables underpinning income from farming and the growth of farm-household income.*" (p.1071) Instead the growth of income in farm households appears to be almost entirely attributable to better integration with the non-farm economy, through opportunities for off-farm employment and incomes.

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Table 1. Support to EU agriculture (total and distribution)

	1986-88	1991-93	1998-00
TOTAL SUPPORT (PSE %)*	44	47	40
Of which (in %)			
Market Price Support and Payments based on Output	92	82	65
Payments based on area planted/animal numbers	2	9	24
Payments based on Input Use	5	6	8
Payments based on historical entitlements, input constraints and farm income**	1	3	3

* PSE%: Producer subsidy equivalent; measures total support to agriculture as a % of the production value.

** For 1991-1993 average, this category also includes miscellaneous Payments (approx. 2% of total)

Source: OECD

*Table 2. Support to agriculture in the EU and the US in 1998 (PSE%)**

	EU	US
Agriculture Total	45	22
Milk	57	61
Sugar	43	41

* PSE%: Producer subsidy equivalent; measures total support to agriculture as a % of the production value.

Source: OECD

Figure 1. Distribution of the EU Agricultural Budget (1991-2006)

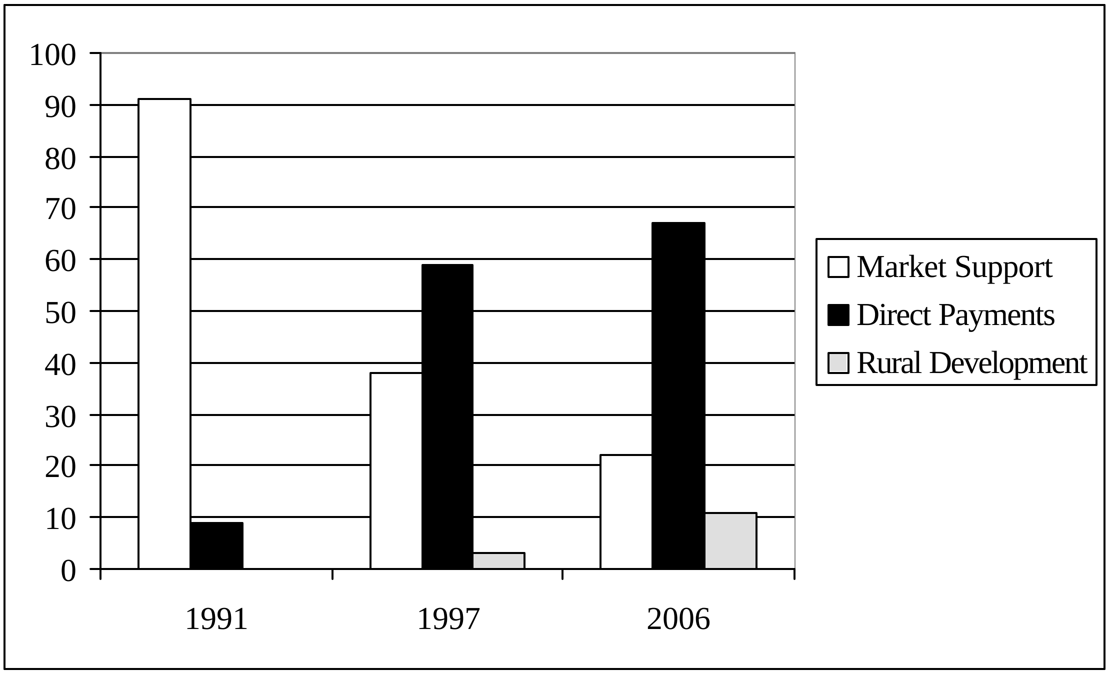
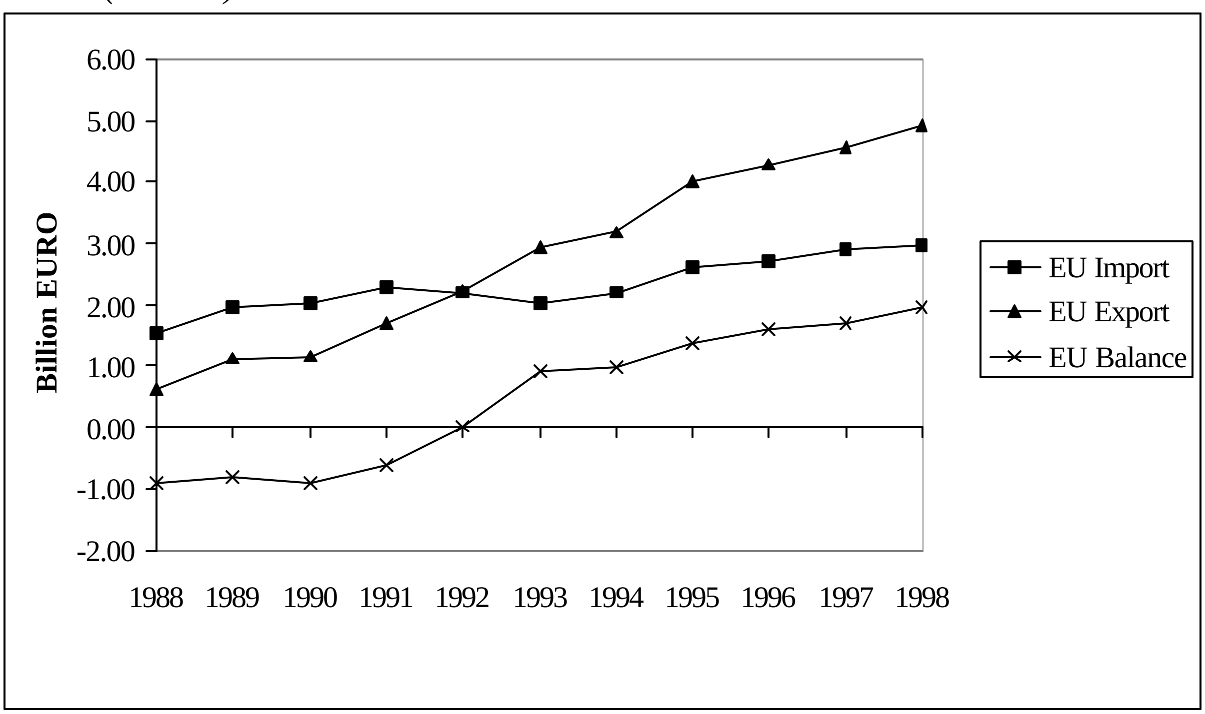


Figure 2. Trade between CEEC-10 and EU-15 in Agricultural and Food Products (Billion €)



Source: European Commission.

Figure 3. Changes in yields 1989-1998

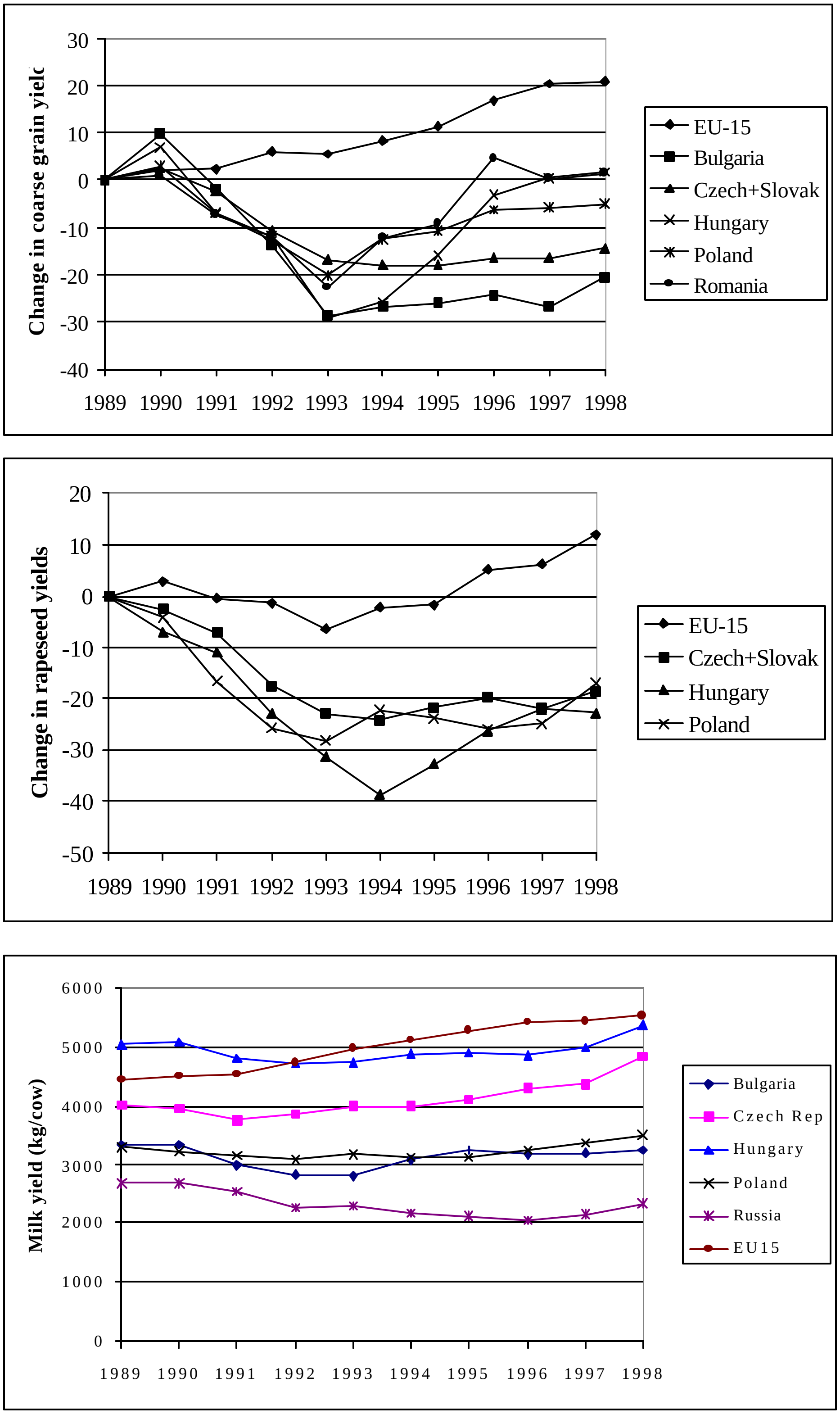


Figure 4. Income levels in CEECs as % of EU-15

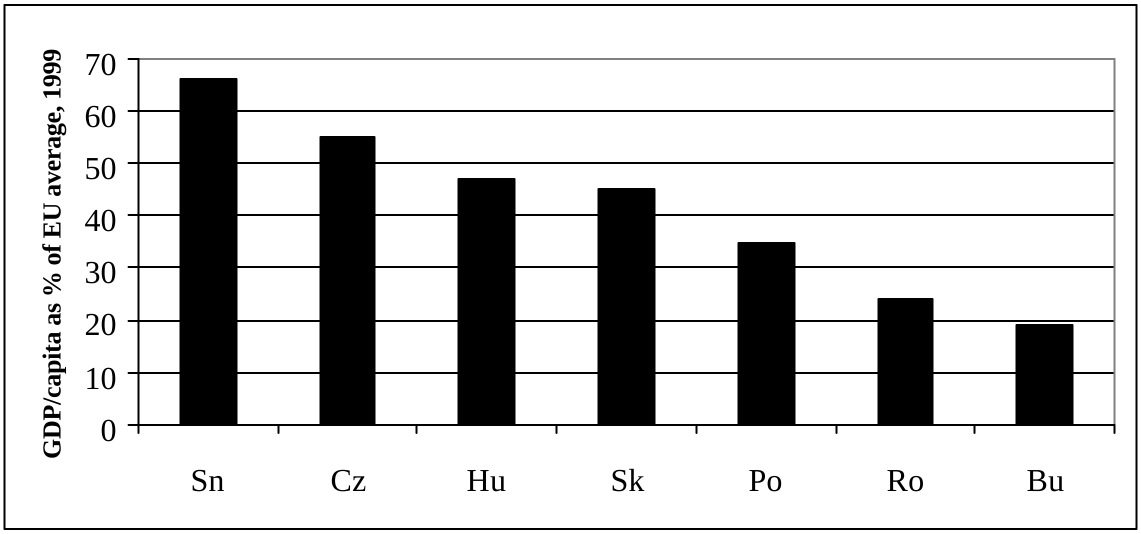
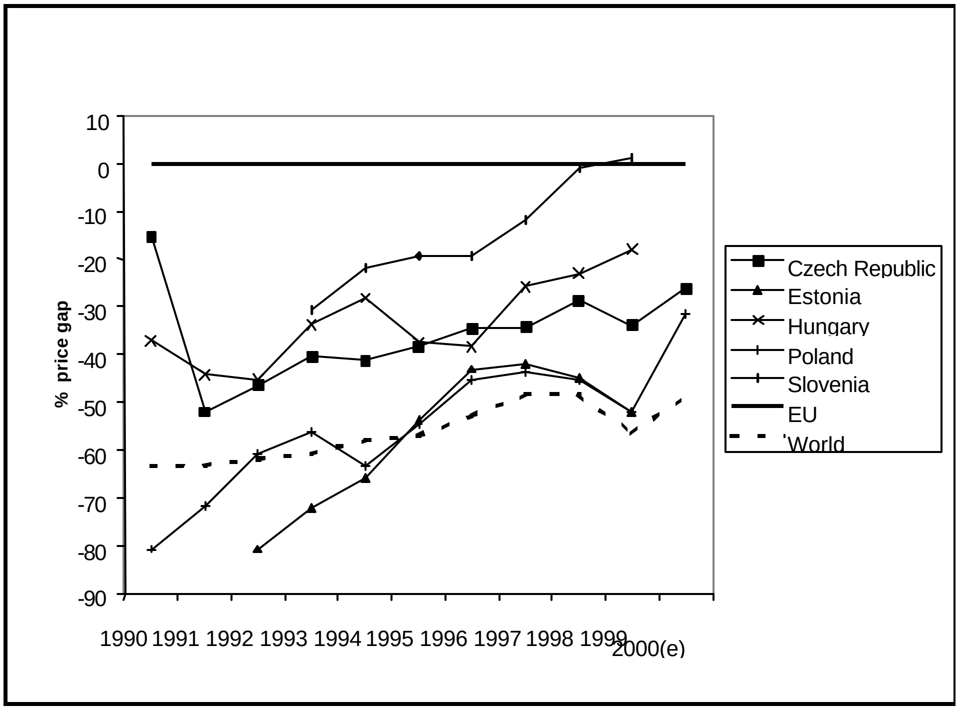


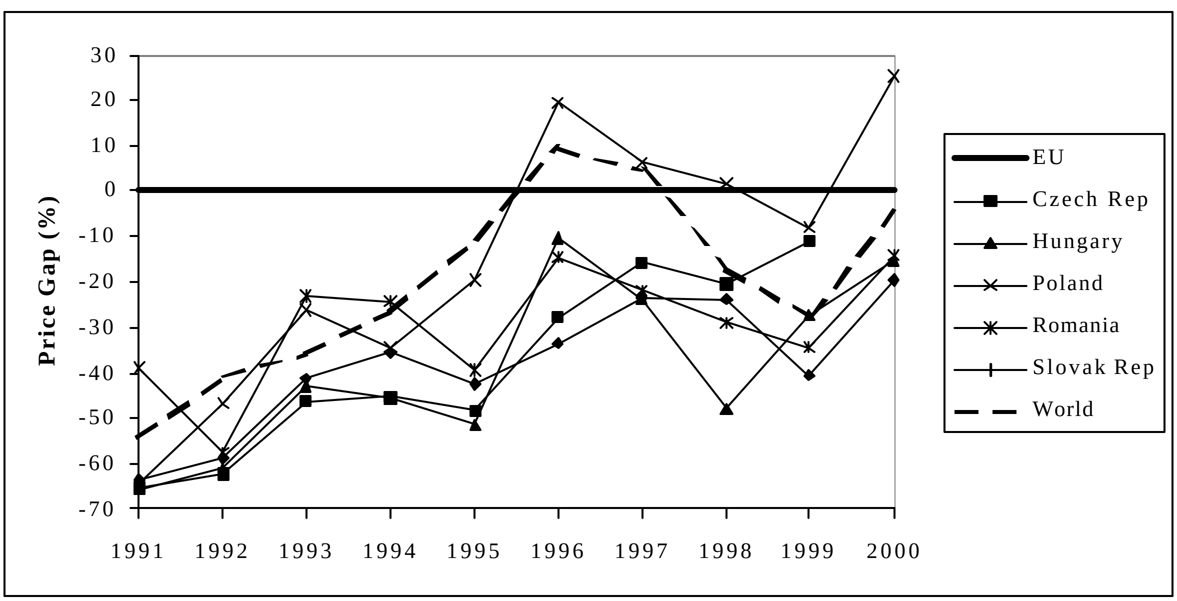
Figure 5 . Price gaps between CEECs and EU-15

Milk



Source: Berkowicz and Münch (2000).

Wheat



Source: Own calculations.

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